No. 14594

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

JACK SMITH and ROSE MAE SMITH,

Appellants,

vs.

HARRY C. WESTOVER, Former Collector of Internal Revenue, and ROBERT A. RIDDELL, Director of Internal Revenue,

Appellees.

On Appeal From the Judgment of the United States District Court for the Southern District of California.

BRIEF FOR THE APPELLEES.

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On Appeal From the Judgment of the United States District Court for the Southern District of Caliifornia.

BRIEF FOR THE APPELLEES.

Opinion Below.

The opinion of the District Court [R. 15-20] is reported in 123 Fed. Supp. 354.

Jurisdiction.

This appeal involves alleged overpayments of income taxes and interest, totaling $119,779.13, for the years 1943 to 1948, inclusive. [R. 8.] All of the amounts were paid to Harry C. Westover, then Collector of Internal Revenue for the Sixth District of California, except the amount of $2,955.17 which was paid to Robert A. Riddell, his successor in that office. [R. 21, 22-23.] Claims for refund were timely filed for all of the taxable years involved.

The claims for refund for the calendar years 1947 and 1948 were filed on March 15, 1951, and March 15, 1952, respectively. [R. 23.]

The Commissioner of Internal Revenue, by registered mail, on February 13, 1951, formally rejected the claims for refund for the calendar years 1943, 1944 and 1945, and on March 15, 1951, formally rejected the claims for the calendar year 1946. The claims for refund for the calendar years 1947 and 1948 had not been formally acted upon by the Commissioner at the time of the commencement of this action. [R. 24.] On February 11, 1953, after the rejection of the claims for refund, and more than six months after the filing of those claims which had not been acted upon by the Commissioner, this suit for refund was instituted in the District Court, all in accordance with the provisions of Section 3772 of the Internal Revenue Code of 1939. [R. 10.] Jurisdiction was conferred on the District Court by 28 U. S. C., Section 1340.

Judgment was entered against the taxpayers on August 23, 1954. [R. 30-31.] Motions to amend the findings and judgment and for a new trial were filed on September 2, 1954, and were denied on September 13, 1954. [R. 32-44.] Within sixty days thereafter, and on November 3, 1954, a notice of appeal to this Court was filed by the taxpayers. [R. 44.] Jurisdiction is conferred on this Court by 28 U. S. C., Section 1291.

Question Presented.

Whether the District Court erred in concluding, upon all of the evidence, that the taxpayers did not intend, in good faith and acting with a business purpose, to enter into partnership, during the years 1943 through 1948, with two trusts set up by them for their two minor children.

Statute Involved.

The pertinent provisions of the statute involved are found in the Appendix, *infra*.

Statement.

The pertinent facts, substantially as found by the District Court [R. 21-28], are as follows:

The taxpayers, Jack and Rose Mae Smith, are husband and wife and residents of the State of California. [R. 21.] Before his marriage to Rose Mae, Jack Smith successfully established a wholesale shoe business known as the Boston Shoe Company. After marriage they considered that the business was community property to which the husband's earning capacity contributed, and on December 31, 1942, Jack bought out Rose Mae's interest for $102,933.89, the purchase price being represented by four promissory notes. Three of these were in the principal amount of $30,000 and the fourth in the amount of $12,-933.89. They were due one, two, three and four years from date, respectively, and bore interest at the rate of 10% per annum. [R. 24, 169-171.]

On September 29, 1943, two trusts were created by Jack and Rose Mae Smith for the benefit of their two minor children, Howard Samuel, then aged 11, and Barbara Ann, then aged 3. Jack Smith was the settlor and Rose Mae the original trustee of the trust for their son Howard. The corpus of the trust consisted of three United States certificates of indebtedness totaling $30,000. Rose Mae was the settlor and Jack the original trustee of the trust for their daughter, Barbara, the corpus of which consisted of the $30,000 note executed by Jack to Rose Mae on December 31, 1942, which became due three years from

the date of execution. The trusts are irrevocable, and are subject to the absolute power of the parents as trustees, the beneficiaries having only "the right to enforce" performance. The distribution of the income is controlled by the trustee. So is the investment of the principal. The children have a graduated right to the distribution of the corpus of the trusts, one-fourth upon rearching the age of 25, one-fourth at 30, and the balance at 35. [R. 24-26, 171- 195.]

Almost simultaneously with the creation of the two trusts an alleged partnership in the shoe business was entered into effective September 30, 1943, consisting of the members of the family. Jack Smith was assigned 40%; Rose Mae Smith, 30%; and the trusts 15% each in the Boston Shoe Company. The wife acquired her interest by surrendering a $60,000 note executed to her by Jack Smith. Both trusts exchanged their assets for the respective interests in the new partnership. [R. 26.]

Under the terms of the partnership, which was modified at one time by including an employee, then returned to the original state, control continued to be exercised by Jack Smith. [R. 26.] The partnership could not conduct business transactions, enter into any contract or incur any liability during his lifetime and continuance as a partner without his approval and consent, and no amendment of the partnership could be made without his consent. He had the power to terminate the partnership interests and to purchase the partnership at book value. [R. 27, 28.]

The main partners, the taxpayers here, retained the power to determine the amount of the salaries to be paid to themselves, which salaries were to be paid before any "distributive net profits" and were to be considered part of the cost of "doing business." Salaries of $25,000 per year for the husband and $2,400 for the wife were provided for under the first partnership agreement and thereafter continued under other arrangements. [R. 26-27.] The first partnership agreement provided that the partnership should have a life of twenty years; however, under subsequent arrangements entered into some 13 months later the life of the partnership was set at three years, and thereafter for successive minimum terms of two years. [R. 27, 217, 250.]

The taxpayers, as trustees for their children, represented the children in the partnership, since the children had no direct or independent voice therein, and at all times control was exercised and maintained by the taxpayers, and the creation of the partnership with the trusts effected no change in the control of the business. [R. 27-28.] There was no judicial control of the children's interests through a court controlled trustee or through a guardianship of the estate of the minors. There was no expectation that the children would ever go into the business. The children through the trusts or otherwise added neither fresh capital nor skill, nor even the future expectation of services. [R. 28.]

The District Court concluded that neither the children nor the trusts for the children intended to or did enter into

a *bona fide* partnership with their parents for a business purpose, and that therefore the partnerships entered into between the trusts and the taxpayers had no validity for income tax purposes for the years 1943 to 1948, inclusive. [R. 29.] The District Court entered judgment accordingly [R. 30-31], from which the taxpayers have taken the instant appeal. [R. 44.]

Summary of Argument.

In holding that the two trusts created by the taxpayers for the benefit of their two minor children were not partners in the wholesale shoe business conducted by the Boston Shoe Company, the District Court followed the principles prescribed by the Supreme Court and applied by this and other courts in numerous family partnership cases. The issue is who earned the business income, and its determination depends upon whether the parties intended to and did in good faith join together to carry on business as partners. This presents a question of ultimate fact, the District Court's determination of which should not be disturbed unless clearly erroneous. While no single factor is conclusive, absence of a contribution of original capital by the alleged partners, or of vital services, or of participation in management, places a heavy burden on the taxpayers.

The record unquestionably warrants the conclusion reached by the District Court that the two trusts for the taxpayers' minor children were not bona fide partners with the taxpayers for tax purposes. The trusts contributed to the business no capital originating with them, the *corpora*

of the two trusts having been supplied by the taxpayers for the purpose of investment in the business. No vital services were rendered to the partnership by either the taxpayers' two children or the trusts for their benefit, and the record indicates that there was no expectation that either of the two children would ever go into the business, since there was no evidence of anticipation that the daughter would ever participate and the son was obviously not preparing himself to go into the shoe business since he was about to attend Harvard Law School. Moreover, the taxpayers controlled the Boston Shoe Company and the creation of the partnership and trusts with respect to their minor children effected no change in the management and control of the business, the children having no independent voice therein, either personally or through the trusts.

The record fails to disclose how this family arrangement, consisting of the trusts and the partnership, served any business purpose of the Boston Shoe Company. The taxpayers testified that the arrangement was to protect and provide security for their minor children. This, if true, discloses a purely personal purpose rather than a business purpose. However, an analysis of what was actually done here indicates that the family arrangement in question did not add anything to the protection and security of the taxpayers' minor children. After this family arrangement was devised, the Boston Shoe Company continued to be operated just as before, and, so far as the evidence discloses, the only real effect of the change was the siphoning off of a part of the taxpayers' profits from a very lucrative business.

Despite the taxpayers' denials, the evidence indicates general tax consciousness on their part and a specific awareness of the possible income tax savings to them which might be accomplished by this arrangement, and upon all of the evidence the conclusion is virtually irresistible that the real purpose of this family partnership could have been nothing but the diminishing of federal tax liability. The existence of the tax avoidance motive supports the inference that the claimed partnership is unreal.

No real change in the economic status of the family has been shown to have resulted from the arrangement involved here, since the taxpayers in actuality retained control of the funds in the trusts and no part of the income the taxability of which is here in issue has ever been distributed to or subjected to the control of the taxpayers' children.

It is clear upon the whole record that the District Court correctly decided this case, since to accord tax effect to this family arrangement would sanction the very type of formalism condemned by the Supreme Court and by this and other courts in like cases.

ARGUMENT.

The District Court Correctly Decided, Upon All the Evidence, That the Taxpayers Did Not Intend, In Good Faith and Acting With a Business Purpose, to Enter Into a Partnership During the Taxable Years 1943 Through 1948 With the Two Trusts Set Up by Them for Their Two Minor Children.

The controversy in this case arises as a result of an attempt by the taxpayers, a husband and wife, to apportion the income from a wholesale shoe business, which was successfully established by the husband, among themselves and two trusts set up for their two minor children through the medium of a family partnership during the taxable years 1943 through 1948. The court below sustained the action of the Commissioner in disregarding the partnership of the children, or the trusts for their benefit, concluding that it had no validity for income tax purposes because [R. 29] "Neither children nor trusts for children either intended to or did enter into a bona fide partnership with their parents for a business purpose." It is our position that this conclusion, resulting from the application of correct legal principles, is amply supported by the record, and should be affirmed.

A. The Applicable Principles.

The controlling principles for differentiating between valid partnerships which were formed to conduct a business as a partnership and family arrangements which were designed to deflect income within the family group were laid down by the Supreme Court in *Commissioner v. Culbertson,* 337 U. S. 733; *Lusthaus v. Commissioner,* 327 U. S. 293; and *Commissioner v. Tower,* 327 U. S. 280. These principles are too well known to require elaborate quota-

tion from the cases having been resorted to by this Court in many instances. *Sellers v. Commissioner,* 218 F. 2d 380; *Snyder v. Westover,* 217 F. 2d 928; *Commissioner v. Sultan,* 210 F. 2d 652, affirming *per curiam,* 18 T. C. 715; *Commissioner v. Brodhead,* 210 F. 2d 652, affirming *per curiam,* 18 T. C. 726; *Wisdom v. United States,* 205 F. 2d 30; *Estate of Cochran v. Commissioner,* decided July 12, 1951 (1951 P-H T. C. Memorandum Decisions, par. 51,219), affirmed *per curiam,* 201 F. 2d 365, certiorari denied, 345 U. S. 974; *Toor v. Westover,* 200 F. 2d 713, certiorari denied, 345 U. S. 975; *Forman v. Commissioner,* 199 F. 2d 881; *Harkness v. Commissioner,* 193 F. 2d 655, certiorari denied, 343 U. S. 945; *Commissioner v. Western Construction Co.,* 191 F. 2d 401, affirming *per curiam,* 14 T. C. 453; *Giffen v. Commissioner,* 190 F. 2d 188, certiorari denied, 342 U. S. 918; *Parker v. Westover,* 186 F. 2d 49; *Nordling v. Commissioner,* 166 F. 2d 703, certiorari denied, 335 U. S. 817; *Quon v. Commissioner,* decided March 28, 1947 (1947 P-H T. C. Memorandum Decisions, par. 47,077), affirmed *per curiam,* 165 F. 2d 215, certiorari denied, 334 U. S. 845. See *Pike v. United States,* No. 14102, argued before this court on February 11, 1955.

In *Commissioner v. Tower, supra* (as was observed by this court in *Snyder v. Westover, supra,* pp. 932-933, in outlining the controlling principles), the Supreme Court found that the husband and wife, a partnership between whom was there questioned, never intended to carry on the business of the partnership and that all of the income was earned by the husband, and, under *Lucas v. Earl,* 281 U. S. 111, 114-115, must be taxed to the party earning it, the court stating (p. 290):

> There can be no question that a wife and a husband may, under certain circumstances, become partners

> for tax, as for other, purposes. If she either invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things she may be a partner * * *. * * *. But when she does not share in the management and control of the business, contributes no vital additional service, and where the husband purports in some way to have given her a partnership interest, the Tax Court may properly take these circumstances into consideration in determining whether the partnership is real within the meaning of the federal revenue laws.

Lusthaus v. Commissioner, supra, was decided upon the same principles. Thereafter, the Tax Court, in deciding family partnership cases, commenced to regard as essential to the validity of a partnership for tax purposes the several elements referred to in the *Tower* and *Lusthaus* opinions merely as constituting circumstances indicating the reality of a family partnership. As a consequence, the Supreme Court, again considering the family partnership question in *Commissioner v. Culbertson, supra,* stated (p. 742):

> The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

While no single factor is "conclusive," failure of the trusts to contribute capital that did not originate elsewhere, or to participate in "management and control of the business," or to perform "vital additional service," in connection with the instant partnership, has the effect of placing "a heavy burden on the taxpayer to show the bona fide intent of the parties to join together as partners." *Commissioner v. Culbertson, supra,* p. 744; *Wisdom v. United States, supra,* p. 34; *Harkness v. Commissioner, supra,* p. 657, fn. 3; *Feldman v. Commissioner,* 186 F. 2d 87, 90 (C. A. 4th). The rationale of the Supreme Court's decisions in the *Tower, Lusthaus,* and *Culbertson* cases is that the trial court is not obliged to accord tax effect to a legally perfect family partnership arrangement which produces no substantial change in the carrying on of the business or the earning of the income therefrom, but merely brings about a reallocation of income within the family group.

> "The statutes of Congress designed to tax income actually earned because of the capital and efforts of each individual member of a joint enterprise are not to be frustrated by state laws which for state purposes prescribe the relations of the members to each other and to outsiders."

Commissioner v. Tower, supra, p. 288. The standards laid down in the *Tower, Lusthaus,* and *Culbertson* cases for measuring the validity of family partnerships for tax purposes apply with the same force where, as here, the taxpayers transfer a portion of their business capital in trust for the benefit of their minor children and an

alleged partnership agreement is made with the trustees. The interposition of the alleged trust, while it may create added legal formalities on paper, does not necessarily make any change in the economic realities within the family group. *Toor v. Westover, supra,* p. 715; *Quon v. Commissioner, supra; Giffen v. Commissioner, supra,* p. 190; *Boyt v. Commissioner,* 209 F. 2d 839, 845 (C. A. 8th), certiorari denied, 347 U. S. 1014; *Feldman v. Commissioner,* 186 F. 2d 87, 91 (C. A. 4th); *Stanback v. Robertson,* 183 F. 2d 889, 892 (C. A. 4th), certiorari denied, 340 U. S. 904. "In tax matters the realities of a transaction, not artificialities, are given effect." *Nordling v. Commissioner, supra,* p. 704.

The vital question in this case, namely, whether the taxpayers, in good faith and acting with a business purpose, intended to join in the operation of the partnership with the two trusts for their minor children is one of ultimate fact and, accordingly, the trial court's disposition of the matter should not be disturbed unless shown to be clearly erroneous (*Toor v. Westover, supra,* p. 717; *Harkness v. Commissioner, supra,* p. 658); that is, the trial court should be sustained unless upon an examination of the entire evidence this court is left with "the definite and firm conviction that a mistake has been committed" (*McAllister v. United States,* 348 U. S. 19, 20; *United States v. Oregon Med. Soc.,* 343 U. S. 326, 339; *Toor v. Westover, supra,* p. 717; *Grace Bros. v. Commissioner,* 173 F. 2d 170, 174 (C. A. 9th)).

B. The Record Amply Supports the District Court's Conclusion That the Family Partnership Here in Question Was Not Valid for Tax Purposes.

It is clear that, in deciding this case, the District Court was correctly advised as to the guiding legal principles [R. 18-19] and that, viewed in the light of those principles the record fully supports its decision.

1. No Contribution of New Capital.

As the court below found [R. 28], the trusts for the taxpayers' minor children brought no "fresh capital" to the Boston Shoe Company upon entering into the partnership agreement of October 1, 1943, with the taxpayers [R. 131-132]. The *corpora* of the two trusts which were conveyed to the business consisted of $30,000 of Government bonds supplied by taxpayer Jack Smith and a $30,000 note supplied by his wife Rose Mae which she had received from her husband, who was the maker thereof, on December 31, 1942, and which was not payable until three years from that date. [R. 194-196, 202-207.] The gist of this transaction was briefly put by taxpayer Jack Smith in response to questions from the court as follows [R. 109]:

> "The Court: How were you getting money for the creation of this trust?
>
> The Witness: Well, first we were going to give it to the kids, and then we thought we could invest it well in our own business.
>
> The Court: Taking back your own money; is that it? You didn't bring in any outside money?
>
> The Witness: Well, we gave it away to them, and we brought it back again.
>
> The Court: I see. It was that way.
>
> The Witness: That's the way we were advised to do it."

2. No Rendition of Vital Services.

The record, in full accord with the District Court's findings [R. 28], discloses that no vital services were rendered to the partnership by either the taxpayers' two minor children or the two trusts for their benefit during the taxable years involved. On the contrary, the trusts rendered no services at all [R. 234-237, 246] and, of course, the taxpayers' daughter and son were only three and eleven years of age, respectively, at the time of the inception of this family partnership [R. 24-25] and there is nothing in the record which suggests that either of them rendered vital services. Moreover, the District Court found that there was no expectation that either of the taxpayers' children would ever go into the business. [R. 28.] The record is devoid of evidence of any anticipation that the daughter would ever participate in the business. At the time of the trial of this case, the son, then 22, had secured a degree in chemistry at Stanford University and had entered Harvard University as a post-graduate student where he had been accepted at the Harvard Law School. [R. 25.] From these facts it is certainly permissible, to say the least, to infer, as the District Court did [R. 25] that the taxpayers' son was not preparing himself to enter the wholesale shoe business. The District Court, in so inferring, was fully within its proper province, for it is the function of the trial court to weigh the testimony, draw inferences, and pass on the credibility of witnesses. *Elmhurst Cemetery Co. v. Commissioner,* 300 U. S. 37, 40; *Helvering v. Kehoe,* 309 U. S. 277, 279; *Helvering v. Nat. Grocery Co.,* 304 U. S. 282, 294-295.

3. No Participation in Management and Control.

The evidence amply warrants the finding below that [R. 27-28]:

> "At all times throughout the years involved control was exercised and maintained by the plaintiffs in this action. The creation of the partnership and trusts effected no change in the control of the business. The children had no independent voice in the management of the business either personally or through the trusts."

The Boston Shoe Company was established by Jack Smith prior to his marriage to Rose Mae. [R. 89.] He is a man of long experience in the wholesale shoe business, having begun actively participating for himself in that business as early as 1919 [R. 85], and in his own words is [R. 86] "considered a man that knows shoes." Certainly, the record leaves little room for doubt but that he exercised the management and control of the Boston Shoe Company both prior to and during the family partnership the tax effects of which are here questioned. This is demonstrated by the salaries paid by the business during the period of the partnership agreements. [R. 235-236, 246.] He was the [R. 116] "head man" throughout, and every indication is that it was never contemplated that either the children or the trusts for their benefit should exercise any management or control over the business. [R. 66, 72-73, 127-128.] Jack Smith made the major decisions in connection with the business and the children had no independent voice in it whatever, as the District Court, concerning itself with the operation in practice, brought out [R. 136]:

> "The Court: You never took a vote with your wife or children to decide by a majority vote what you were going to do?

The Witness: Oh, with my wife, yes, I would discuss certain things.

The Court: You would discuss it with her?

The Witness: Yes.

The Court: But with the children?

The Witness: With the children, no.

The Court: So whatever you and your wife decided had to bind the children?

The Witness: That's right, yes."

4. No Business Purpose for Including the Trusts as Partners.

The record fails to disclose any business purpose of the Boston Shoe Company to be served by the family arrangement challenged here. On the contrary, it is replete with testimony that the purpose of the trusts was to protect and provide security for the taxpayers' minor children. [R. 65-66, 70, 74, 93, 99, 125.] It is, of course, entirely natural for parents to be concerned for the welfare of their children. However, actions taken from such a motive are obviously purely personal in nature and can scarcely be said to serve any business purpose. It should be added, however, that there is little logic in the taxpayers' contention that their purpose was to provide security for their children through the medium of the trusts and the family partnership arrangement. As Jack Smith testified, he was fully aware of the fact that he could leave such property as he wished to his children by will, and, in fact, had a will drawn. He added nothing to his children's security by tying such gifts as were made them to the business which was already the means of the family support. [R. 125-130.] While taxpayer Jack Smith suggested that the purpose of making the trusts partners was because [R. 108] "the money be-

gan to be needed. * * *. * * * we needed a little bit more capital in the business, too * * *," it is clear, as we have discussed previously herein, that this family arrangement brought no new capital into the family business. We find nothing in the record which indicates how the business of the Boston Shoe Company was in any manner served by the trusts and family partnership. On the contrary, it is clear that the business continued to be operated just as it had been prior to this arrangement and, in so far as the evidence discloses, the only change effected by the inclusion of the trusts as partners was the siphoning off of a part of the taxpayers' profits from a business which [R. 77] "At that time * * * was a very lucrative one."

The taxpayers both denied that the transactions at issue here were at all motivated by tax considerations. [R. 73, 107.] However, this self-serving testimony, as the trial judge observed [R. 73], "is not necessarily binding on the court, because it must be considered against the background of the facts." Furthermore, other evidence suggests that the taxpayers may not have been nearly so unconcerned with tax considerations in their activities as their denials would lead one to believe. In 1942 it appears that each of the taxpayers' children was given [R. 67] "a small gift of three or four thousand dollars, I don't recall, *whatever the Government allowed.*" (Italics supplied.) And in 1943, upon their son's graduation from Stanford, the taxpayers each gave him $3,000. This amount also happened to be just what *the Government*

allowed, and the same may be said of the two $30,000 gifts made in trust for the children in 1943.[1] Thus, each of the gifts disclosed by the record is in precisely the maximum amount, no more and no less, which it may have been possible under the law to give without the payment of any federal gift tax. Beyond this, Jack Smith, while denying that the creation of the family arrangement in dispute here was purposed to save income taxes, nevertheless conceded that [R. 107] "It may have been explained that it might save." It appears, therefore, that not only were the taxpayers generally tax conscious in their activities here, but specifically they were fully aware of the income tax savings anticipated from the family partnership. To believe otherwise would be naive in the extreme. We submit that, upon all of the evidence, the conclusion is practically inescapable that the real purpose of this family partnership could have been nothing but the diminishing of federal tax liability. Existence of a tax avoidance motive "simply lends further support to the inference" that the claimed partnership is unreal. *Commissioner v. Tower, supra,* p. 289.

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[1]Section 1003(b)(3) of the Internal Revenue Code of 1939, as added by Section 454 of the Revenue Act of 1942, c. 619, 56 Stat. 798 (26 U. S. C. 1952 ed., Sec. 1003), provides for an annual exclusion of the first $3,000 of gifts made by a donor to any person during the calendar year 1943 and subsequent calendar years. Section 1004 of the Internal Revenue Code of 1939, as amended by Section 455 of the Revenue Act of 1942, *supra* (26 U. S. C. 1952 ed., Sec. 1004), allows each donor a specific exemption in the amount of $30,000 which he may allocate against his gifts from year to year as he sees fit until the exemption is exhausted.

5. No Real Change in the Economic Status of the Family.

The Supreme Court, in the *Tower* case, *supra,* pages 291-292, noted that if a partnership brings about no real change in the economic relationships of a family to the income in question, the result of the so-called partnership will be a "mere paper reallocation of income among the family members." That principle clearly seems to be appropriate here. The position of the taxpayers rests heavily upon "paper," that is, the written provisions of the trust and partnership instruments which they had prepared, and the legal consequences said to flow therefrom under state law. Of course, as we have previously observed herein, state law is not controlling here, and the Government is not bound by the legal effect thereunder of written agreements between parents and their children. If it were otherwise, taxpayers could readily frustrate the purpose of Congress to tax income to the members of the family who actually earn it. However legal and enforcible an agreement between parents and their children, the execution of which is in no way subjected to the interests of outsiders, may be under state law, the important reality is that such persons usually are not dealing with each other at arm's length. The family ties and relationships between the parties to such agreements may leave the beneficiaries thereof neither free nor disposed to enforce them in actuality. In such a case "The actualities of their relation to the income * * * [does] not change." *Commissioner v. Tower, supra,* p. 292. In so far as the record here discloses, the taxpayers have not shown the existence of any real change in the economic status of the family. Significantly, after the taxpayers were advised that the Federal Government and the State of California would

not recognize this family arrangement for tax purposes, they simply had prepared an additional "paper" whereby they agreed between themselves as individuals and as trustees of the trusts for their children that the trusts should bear the burden of the additional taxes to be imposed against them individually. [R. 268-272.][2] The realities of the situation here are fully indicated by this action. Obviously, the trust assets are readily accessible to the taxpayers and they may, with the same facility with which they dipped into them to pay their personal tax liabilities, resort to such assets for other purposes. [R. 50.]

It must be observed that no distribution of the income here involved has been made by the taxpayers to their children. While under the trust instruments, the trustees had the discretion within certain limits to advance sums for the maintenance, support and medical care of the beneficiaries while they were between the ages of 21 and 25, the beneficiaries have no power to draw against the trust estates prior to their attaining the age of 25. [R. 105, 177-179.] The taxpayers' son has never been consulted about what was to be done with the trust money since he became of age [R. 105], nor is there any indication in the record that either of the children ever exercised any actual control over the income, the taxability of which is here in issue.

Finally, the taxpayers assert (Br. 39) that regardless of all other considerations the judgment of the trial court must be reversed because that court made no finding of

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[2]It is noteworthy that in this agreement the taxpayers, just as did the District Court [R. 26], treated this family arrangement as one continuing family partnership, and attached no significance to the fact that there was more than one written partnership agreement.

fact as to lack of good faith in the formation of the partnership.[3] The taxpayers in this connection rely upon this Court's decision in *Snyder v. Westover,* 217 F. 2d 928. But the instant proceeding is entirely different from the *Snyder* case. In the latter suit (p. 935) "The trial court did not make any finding as to lack of good faith on the part of the parties in the formation of their apparently valid partnership," whereas here, as the taxpayers concede (Br. 39), the trial court included in its conclusions of law a statement that: "Neither children nor trusts for children either intended to or did enter into a bona fide partnership with their parents for a business purpose." [R. 29.] The fact that this statement (which is in the nature of an ultimate finding supported by many of the evidentiary facts set forth in the findings of fact and the record in general) appears under the conclusions does not change the essential factual nature thereof, and since this statement in the conclusions "provides a clear understanding of the basis of the decision below * * * the absence of findings of fact * * * is not sufficient to justify a reversal in this case." *Burnham Chemical Co.*

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[3]Inconsistently the taxpayers assert in the last paragraph of their argument under this point (Br. 40):

> In calling to this Court's attention the failure of the trial court to make the finding of fact just referred to, we are not suggesting that this proceeding be remanded to the trial court. We respectfully submit that no such remand is here necessary. We are merely calling this situation to this Court's attention as a further indication of the trial court's failure to correctly find the facts involved and apply the law applicable.

Moreover, it seems clear that such a remand would be entirely an unnecessary formality since, as we will point out hereinafter, the District Court's view as to lack of good faith is already stated in its conclusions of law.

v. Borax Consolidated, 170 F. 2d 569, 574 (C. A. 9th), certiorari denied, 336 U. S. 924, rehearing denied, 336 U. S. 955. It may perhaps have been inappropriate to place this vital finding under the heading of "Conclusions of Law," but we submit that the court's action is not of such a nature as presents a ground for a reversal by this Court. As this Court stated in *Refrigeration Engineering v. York Corp.,* 168 F. 2d 896, 900, certiorari denied, 335 U. S. 859:

> The trial court "concluded" that plaintiff had infringed claim 13 * * *. Plaintiff says that the court did not make any finding of fact to support this "conclusion" and erred in failing to make such a finding. Actually, this so-called conclusion was a finding of fact. It was error to call it a conclusion of law, but the error does not require reversal of the judgment. *Baldwin Rubber Co. v. Paine & Williams Co.,* 6 Cir., 99 F. 2d 1; *Minnesota Mining & Mfg. Co. v. Coe,* 75 U. S. App. D. C. 131, 125 F. 2d 198; *Smith v. Fletcher,* 80 U. S. App. D. C. 263, 152 F. 2d 20.

To hold that the District Court was obliged as a matter of law to accord tax effect to the instant arrangement would sanction the very type of formalism repeatedly condemned by the Supreme Court and by this and other courts in like case. It is respectfully submitted that the District Court's decision in this case is fully in accord with the actualities as revealed by the record, and is not clearly erroneous.

Conclusion.

The judgment below is correct and should be sustained.

Respectfully submitted,

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April, 1955.

APPENDIX.

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

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(26 U. S. C. 1952 ed., Sec. 22.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

(26 U. S. C. 1952 ed., Sec. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * * * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b).

(26 U. S. C. 1952 ed., Sec. 182.)

SEC. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * * * * * * *

(2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

* * * * * * * * *

(26 U. S. C. 1946 ed., Sec. 3797.)